

Federal Reserve Bank of San Francisco
101 Market Street, San Francisco, California 94105

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**BANKING SUPERVISION AND REGULATION:
FINAL RULES**

To State Member Banks, Bank
Holding Companies, U.S. Branches
and Agencies of Foreign Banks,
and Others Concerned,
in the Twelfth Federal Reserve District

Final Rules to Implement Basel II Risk-Based Capital Framework

The Federal Reserve Board approved final rules to implement new risk-based capital requirements in the United States for large, internationally active banking organizations. The new advanced capital adequacy framework, known as Basel II, more closely aligns regulatory capital requirements with actual risks and should further strengthen banking organizations' risk-management practices.

For banking organizations that meet the relevant qualifying criteria, Basel II would replace the current U.S. rules implementing the Basel Capital Accord of 1988 (Basel I). Basel II would be mandatory for large, internationally active banking organizations (so-called "core" banking organizations with at least \$250 billion in total assets or at least \$10 billion in foreign exposure) and optional for others. Under Basel II, core banking organizations would be required to enhance the measurement and management of their risks, including credit risk and operational risk through the use of advanced approaches for calculating risk-based capital requirements.

Core banking organizations would also be required to have rigorous processes for assessing their overall capital adequacy in relation to their total risk profile and to publicly disclose information about their risk profile and capital adequacy. Under Basel II, risk-based capital requirements will vary on the basis of a banking organization's actual risk profile and experience, which should lead institutions to make better decisions about extending credit, mitigating risks, and determining overall capital needs. Banking organizations with a higher risk profile will have higher regulatory capital requirements than those with a lower risk profile.

The new U.S. Basel II rule is technically consistent in most respects with international approaches and includes a number of prudential safeguards as originally proposed in September 2006. These safeguards include a requirement that banking organizations satisfactorily complete a four-quarter parallel run period before operating under the Basel II framework, a requirement that an institution satisfactorily complete a series of transitional periods before operating under Basel II without floors, and a commitment by the agencies to conduct ongoing analysis of the framework to ensure Basel II is working as intended. Importantly, Basel II in the United States will be implemented with retention of the leverage ratio and prompt corrective action (PCA) requirements, which will continue to bolster capital and complement risk-based measures.

Following a successful parallel run period, a banking organization would have to progress through three transitional periods (each lasting at least one year), during which there would be floors on potential declines in risk-based capital requirements.

Those transitional floors would limit maximum cumulative reductions of a banking organization's risk-based capital requirements to 5 percent during the first transitional floor period, 10 percent during the second

transitional floor period, and 15 percent during the third transitional floor period. A banking organization would need approval from its primary federal regulator to move into each of the transitional floor periods, and at the end of the third transitional floor period to move to full Basel II. The federal banking agencies will publish a study after the end of the second transition year that examines the new framework for any material deficiencies.

The agencies intend to issue a proposed rule that would provide all non-core banking organizations, which are not required to adopt Basel II's advanced approaches, with the option to adopt a standardized approach under Basel II. The proposed rule is intended to be finalized before the core banking organizations may start their first transition period year under Basel II.

Additional Information

All circulars and documents are available on the Internet through the Federal Reserve Bank of San Francisco's website, at <http://www.frbsf.org/banking/letters>.

For additional information, please contact our Federal Reserve Consumer Help Line at (866) 838-9247.

FEDERAL RESERVE BANK OF SAN FRANCISCO

Attachments: [Statement by Chairman Ben S. Bernanke](#)
[Statement by Governor Randall S. Kroszner](#)
[Docket No. R-1261](#)